

Getting Housing Finance Back on Track

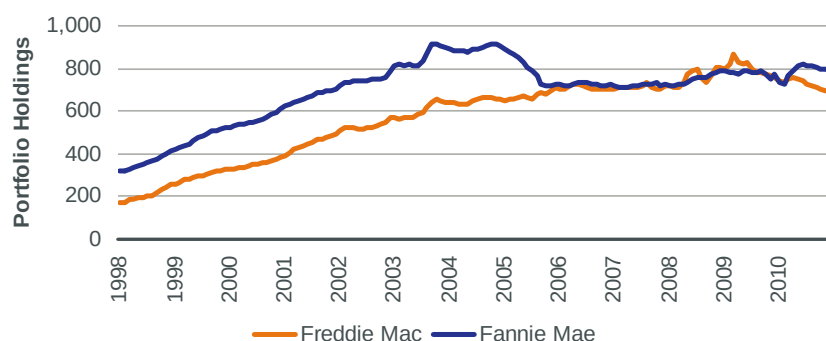
Background

Thirty years ago, home buyers needed a substantial down payment *plus* evidence of sufficient income to make their monthly mortgage payments *plus* a clean credit history in order to get a home mortgage. Back then, Fannie Mae and Freddie Mac were critical players in the mortgage market, establishing strict underwriting criteria to put their guarantee on what were commonly known as “conforming mortgages.” Three years ago, home buyers often purchased homes with no money down, no documentation of income or savings, and very low credit scores. This practice became commonly known as “sub-prime lending.” The ensuing failures of Ameriquest, Countrywide, IndyMac and other lenders along with the troubles of Fannie Mae and Freddie Mac are well documented. How did we stray so far from basic underwriting standards, and how can we get the mortgage market and housing finance back on track to support housing?

A key question in the debate centers on the need for and degree of government support of housing. Before tackling this question, it is worth understanding the structure of the government-sponsored enterprises (GSEs) and their role in the crisis. First, their private profit / public loss structure was unique amongst financial institutions. Both Fannie and Freddie had public shareholders and ran for-profit businesses with commensurate incentives to compensate employees and shareholders. Second, the GSEs benefited from the perception of being quasi-governmental entities. This allowed them to borrow funds relatively cheaply and invest in mortgages and mortgage securities, actually growing their balance sheets substantially. Given their quasi-governmental status, Fannie and Freddie were also encouraged to meet public policy goals associated with expanding home ownership and providing “affordable housing” to low income buyers. During the past two decades, as sub-prime lending became the norm in the mortgage market, the GSEs found themselves becoming irrelevant unless they agreed to modify their relatively conservative underwriting guidelines. The rest is history.

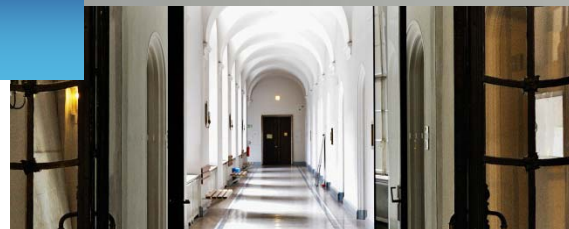
For many years, US home buyers benefited from the availability of affordable mortgage loans. Likewise, a wide range of investors were attracted to high quality assets that met the needs of their portfolios. In essence, strict underwriting standards *combined with the guarantee of the GSEs* facilitated the creation of a liquid secondary market for mortgages

Figure 1: Growth of GSE mortgage portfolios over time (US\$ billions)



Source: Fannie Mae, Freddie Mac; data through 31 December 2010

The opinions expressed are as of February 2011 and may change as subsequent conditions vary.



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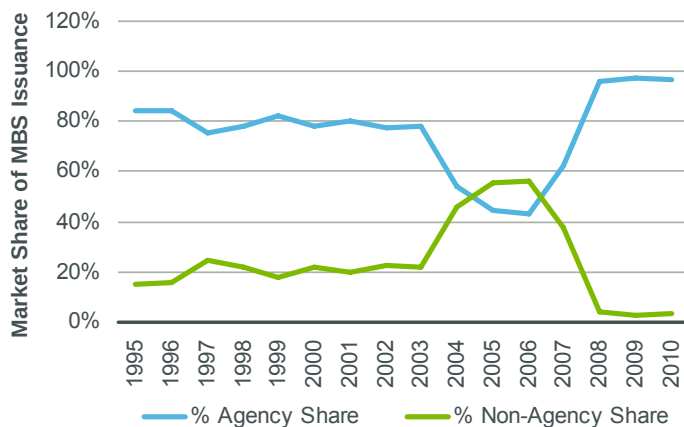


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with capital flowing into the sector from insurance companies, mutual funds, pension plans, sovereign wealth funds, and other investors around the world. These same investors have never expressed as strong an interest in “private-label” (or non-government-guaranteed mortgages), even when the private-label mortgages have been offered at higher yields. Mortgages typically have a 15-year or 30-year maturity with monthly paydowns of principal and a prepayment option held by the homeowner. Unfortunately, these features create assets that are not natural portfolio holdings for most banks or savings institutions. As a result, some form of government support will be important to the future of housing finance.

As we consider whether or not there should be public support for housing, we need to learn from both the successes and the failures of past programs. The original GSE mandate and programs were very positive for housing, whereas several critical flaws in structure, incentives, and changes in mandate took them down a destructive path. Given the importance of housing and home ownership in the US, there has been a long history of government involvement, including tax policy as well as guarantees, special programs, and portfolio purchases. We believe that a purely private sector solution will be extremely disruptive to the already fragile housing markets.

Figure 2: MBS issuance over time



Source: Inside MBS & ABS, CoreLogic, Amherst Securities; data through 31 December 2010

Guiding Principles in Approaching Housing Finance in the US

The starting point of any solution must include broad agreement on a clear mission. A second stipulation must be simplicity and transparency. Highlights of a recommended approach include:

1. Government guarantee of mortgage pass-throughs

The US housing market has been supported by capital from a diverse group of investors purchasing mortgage pass-throughs

in the secondary market. The credit quality and fungibility of agency pass-throughs, which create an orderly and robust secondary market, is the bedrock of this system. While private securitization and covered bonds have a role in the future of housing finance, they cannot function as the cornerstone of the US mortgage market given the size of this market and the capital required. While the format of the guarantee and the entity providing the guarantee may take one of several forms, it is important for the government to get paid for providing this guarantee.

2. Eliminate current portfolio holdings and limit future purchases

The current GSE portfolio holdings should be capped with mandatory reductions over time, as previously agreed upon, and the portfolios should not be allowed to grow again in the future. Mortgage securities with government guarantees can attract sufficient capital to support the housing market, thereby negating the need for agency portfolio purchases. In the new model, the government agency would become an intermediary in the securitization process.

3. Define conservative underwriting standards

Establish clear criteria for the size of the down payment, required income documentation and verification procedures, and credit scores. Only mortgage loans that meet these criteria should qualify for a government guarantee. Loans not meeting these criteria would need to be funded by the private sector without the benefit of a government guarantee.

4. Establish loan limits by geographic housing markets

During the recent financial crisis, qualifying mortgage loan limits were raised significantly as the private sector for mortgage financing virtually shut down. Over time, loan limits should be set in relationship to the mean home prices in various housing markets. Loans above these limits would need to be funded by the private sector.

5. Focus on “plain vanilla” programs

Rather than trying to be everything to everyone, the government guarantees should be limited to straightforward, fully-amortizing 15-, 20-, and 30-year fixed rate and adjustable rate mortgages conservatively underwritten as described above. Again, other types of mortgages might be offered but would need to be funded by the private sector.

6. Transparency is beneficial at all levels of the process

From originations to securitization to pricing to ongoing reporting to intermediaries, transparency is critical to restoring confidence in our system. Transparency is also critical to inform current and future policy choices.

7. Eliminate uncertainty over investors' rights

Over the past few years, a number of programs have put into question the rights of investors in times of stress. It is important to clarify the rights of first lien holders versus second lien holders, address the potential conflicts of interest in the system, and revamp the servicing model to adequately protect investors' rights in order to attract private capital back to the sector.

8. Clarity of delivery in housing affordability programs

Establish a clear and accountable delivery mechanism for delivery of affordable housing initiatives for both clarity of purpose and accountability for cost. In order to maintain capital markets integrity, avoid intermingling affordable mortgages in generic government-guaranteed mortgage pass-through programs with traditional mortgages. Loan modification, loan forbearance, and other programs that have been launched to aid existing borrowers should be carefully evaluated.

9. Provide support for multi-family housing

Multi-family housing plays an important role in our overall housing markets, and is especially important to fulfill affordable housing objectives. However, multiple competing programs have evolved across multiple government agencies. Clear programs should be established for government guarantees on multi-family as well as single family housing. Given the unique issues involved, conduct a special study focused specifically on multi-family housing.

This "back to the future" solution balances the importance of housing in our economy and home ownership in our social structure with the need to protect taxpayers. By limiting the types and sizes of loans that are eligible for government guarantees and limiting the agencies to providing a credit utility, both homeowners and taxpayers are protected from the abuses and excesses that led to the financial crisis and the subsequent collapse of housing. And, by providing a robust secondary market and attracting significant capital for a large percentage of the mortgage market, the private sector should be able to provide the capital for mortgages outside the bounds of the guarantee programs.

This approach is similar to Option 3 in the recently released Report from the US Treasury. The Report is described in the following sections of this paper.

Thoughts on "Reforming America's Housing Finance Market — A Report to Congress"

On February 11, 2011, The US Departments of the Treasury and Housing and Urban Development jointly issued "Reforming America's Housing Finance Market—A Report to Congress" (the Report). While the Report, as expected, did not make a definitive recommendation for the eventual role of the Federal Government

in financially supporting the US housing market, the Report did make two important points clear:

- ▶ The Federal Government is committed to ensuring that Fannie Mae and Freddie Mac are fully able to meet all the guarantees and direct obligations that they have now issued or will issue in the future. This point is made no fewer than three times in the 31-page Report.
- ▶ Fannie Mae and Freddie Mac will not exist indefinitely but will be wound down in a responsible manner and at a deliberate pace which accounts for the impact that the process will have on borrowers and the housing market.

Commits to winding down the GSEs

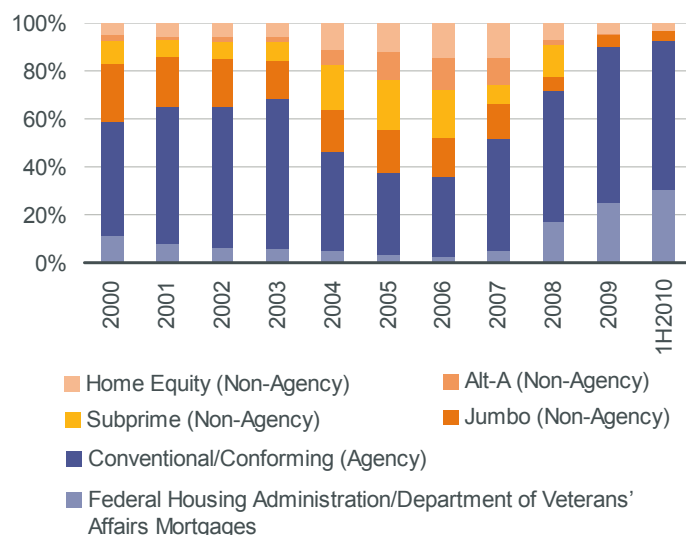
The Report commits to winding down the GSEs to create the conditions for private capital to play the predominant role in housing finance, and sets forth several steps that will be taken in the near-term during the wind-down process. These interim steps include:

- ▶ Increasing the guarantee fee that the GSEs charge borrowers to explicitly reflect the value of such guarantee and the actual insurance risk to Fannie Mae and Freddie Mac.
- ▶ Encourage the GSEs to pursue additional credit-loss protection from private insurers and other private sources of capital. Included in this would be requiring larger down payments by borrowers, raising this requirement over time to a minimum level of at least a 10% down payment.
- ▶ Reducing conforming loan limits approximately 14% from \$729,750 to \$625,500, first by allowing the temporary increase passed in 2008 to expire on October 1, 2011, and then potentially lowering that limit over time. Although \$625,500 is less than the current loan limit, it is still 33% higher than the pre-crisis limit of \$417,000.
- ▶ Winding down the GSEs existing investment portfolios by a minimum of 10% per year. It should be noted that the GSEs are currently reducing their investment portfolios by at least this much.

Proposes the reduction of the role of the Federal Housing Administration (FHA)

In addition to taking these steps during the interim period as the replacement option is debated, the Report also proposes reducing the role of the FHA to its pre-crisis role of providing mortgage credit access only for low- and moderate-income Americans and first-time homebuyers. The Report estimates that such actions would decrease FHA's share of the mortgage market from its current 30% to its more historic share of 10% to 15%. This reduction in the FHA's role would be replaced by the private market, not the GSEs. It will be started by allowing the maximum size loan it can insure to be decreased in the same manner as set forth for the GSEs previously, plus increasing the annual mortgage insurance premium by 25 basis points for the Federal Government's next fiscal year.

Figure 3: Annual mortgage originations by sector: increasing agency originations since crisis (as a percentage of total)



Source: J.P. Morgan, Inside Mortgage Finance, Ginnie Mae, Fannie Mae, Freddie Mac; 2010 data through 30 June 2010

The Report analyzes each of the three proposed Options for what will replace the GSEs and we believe from the tone of the analyses that the preferred choice is Option 3.

Option 1 has many drawbacks

We believe Option 1, which is total privatization away from the narrow, targeted roles of FHA, USDA and VA, while initially seeming to be the most protective of the taxpayer, has many drawbacks, which the Report characterizes as “acute costs,” not the least of which is that this Option would most likely see the demise of the 30-year fixed rate mortgage that has been the backbone of homeownership in the US. The other acute costs noted in the Report include an increase in the cost of mortgage credit generally, as well as a decrease in the accessibility of that credit. A further concern is that in a totally private market, the Federal Government could not effectively step in to ensure access to mortgage credit in a crisis, potentially exacerbating a severe downturn and risk greater cost to the taxpayer to deal with the effects of such a downturn.

Option 2 allows the Federal Government to act in a time of crisis, but may be unsustainable

We believe Option 2, which is Option 1 plus the addition of a guarantee mechanism that would be scaled up to stabilize the mortgage market in times of stress, is somewhat more appealing because it provides a role for the Federal Government to stabilize the economy in a time of crisis that is absent from Option 1. However, the significant operational challenges of designing and maintaining an organization that is mostly dormant in normal times are probably too daunting to make Option 2 workable. In addition, mortgage rates would be higher in normal times as is the case for Option 1.

The tone of the Report leads us to believe Option 3 is favored relative to other options

This leads to Option 3, which is very close to the structure proposed in a research paper published last year by the Federal Reserve Bank of New York. This Option provides for primary guarantee support of mortgages by a private cooperative or consortium that would have stringent capital requirements and regulatory oversight provided by the Federal Government. The Federal Government would then offer reinsurance of certain eligible privately-insured mortgages. The Report lists several benefits of this Option and argues this structure would lead to the lowest cost for mortgages as well as the greatest access to mortgage credit. It provides for taxpayer protection as the primary insurance would be provided by highly capitalized and regulated entities with the government reinsurance properly priced to build reserves to be used in times of financial crisis. It allows the Federal Government to have a direct role with an

Considers three options to replace the GSEs

The Report is less clear on what will replace Fannie Mae and Freddie Mac. In considering the replacement, the Report lists four key criteria that should guide the decision:

- ▶ Access to mortgage credit,
- ▶ Incentives for investment in the housing sector,
- ▶ Taxpayer protection, and
- ▶ Financial and economic stability.

The Report concludes by outlining three potential options for replacing the GSEs:

Option 1: A privatized system of housing finance with the government insurance role limited to providing assistance to narrowly targeted groups of borrowers, including the FHA, the US Department of Agriculture (USDA), and the Department of Veterans' Affairs (VA).

Option 2: Option 1 plus a Federal Government guarantee mechanism that would be established, but only scaled up during times of financial crisis.

Option 3: Option 1 plus a continuous catastrophic reinsurance program guaranteed by the Federal Government that would be used to back primary guarantees sourced solely with significant private capital.

established mechanism to provide financial and economic stability. Finally, the reinsurance aspect should attract private capital into the housing market. In fact, that is also seen as a drawback in the Report as the government reinsurance guarantee could cause too much capital to flow into the housing sector, drawing capital away from other potentially more productive sectors and artificially inflating the value of housing assets. However, as noted previously, the tone of the Report leads us to believe that Option 3 is the one favored most by the Treasury and the US Department of Housing and Urban Development (HUD).

Report Generally Positive for Agency Mortgages and Responsive to Investor Concerns

We think the issuance of the Report is generally positive for the agency and non-agency MBS markets. First, the Report removes

uncertainty as the issuance of the Report itself has replaced the rumor and tail risk of the unexpected has been removed. Second, the interim steps to be taken to wind down the GSEs will reduce agency MBS supply, thus supporting mortgage valuations. These steps include increases in fees and decreases in the size of mortgages that can be insured. This, in turn, will decrease the supply of agency mortgages from both refinancings and purchases of homes. In addition, the tone of the Report reflects the importance of attracting capital to this marketplace, going so far as to explicitly acknowledge the importance of transparency, the need to reform mortgage servicing, and the need to improve the treatment of lien priority. Option 3, which echoes the option laid out in the Federal Reserve Bank of New York's research paper, appears to be a practical solution that would likely be well accepted by the market as a positive step for MBS given that the current GSE structure would not continue indefinitely. In summary, we are encouraged by the release and content of the Report and view it as being a positive step for mortgages.

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